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Re: Announcement 2004-98 – Comments Regarding the Advance Pricing Agreement Program

Dear Messrs. Korb, Hicks and Frank:

The enclosed comments respond to Announcement 2004-98, which requested comments regarding the operation of the Advance Pricing Agreement Program. The comments were prepared by members of the Section of Taxation's Committee on Transfer Pricing. These comments represent the individual views of those members who prepared them and do not represent the position of the American Bar Association or of the Section of Taxation.

Sincerely,

Kenneth W. Gideon
Chair, Section of Taxation

Enclosure

Comments on the Advance Pricing Agreement Program

The following comments were prepared by individual members of the Committee on Transfer Pricing of the Section of Taxation. These comments are the individual views of the members of the Section of Taxation who prepared them and do not represent the position of the American Bar Association or the Section of Taxation.

Principal responsibility for the preparation of these comments was exercised by Darrin Litsky. Dan Karen, Karl Kellar, Robert Kirschenbaum, Mark Martin, and Clisson Rexford made substantive contributions. The Comments were reviewed by Steve Wrappe, Chair of the Committee on Transfer Pricing. The comments were also reviewed by Robert E. Liles, II, of the Section of Taxation's Committee on Government Submissions and by N. Susan Stone, as Council Director for the Committee on Transfer Pricing.

Although many of the members of the Section of Taxation who participated in preparing these comments have clients who would be affected by these comments or have advised clients on the application of Advance Pricing Agreement requests, no such member (or the firm or organization to which each member belongs) has been engaged by a client to make a government submission with respect to, or otherwise to influence the development or outcome of, the specific subject matter of these comments.

One member who contributed to these comments is an employee of a company that has a currently effective APA and that could be affected by any changes in the APA Program. The member has not, however, been personally involved in lobbying or otherwise specifically trying to influence the development or outcome of specific aspects of the Advance Pricing Agreement Program.

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Date: February 17, 2005

Executive Summary

The Internal Revenue Service's ("Service or "IRS") Advance Pricing Agreement Program ("APA Program") has been reviewed and subject to scrutiny throughout its fourteen year history. Despite this scrutiny and diverted resources to address inquiries and lawsuits into its activities, the APA Program has completed over 500 advance pricing agreements ("APAs") and has served as an example for other countries developing or presently operating APA Programs.

Announcement 2004-98 asks for comments regarding operation of the APA Program and recommendations for strengthening the APA Program's performance. Our specific comments and recommendations include:

- Resource constraints in personnel and travel funds have made it difficult for the APA Program to operate as well as it could. We recommend that the APA Program be fully staffed to meet its timeliness goals and be provided additional staff to respond to the government inquiries and lawsuits into its activities.

- We appreciate the Service's consideration of consistency amongst "similarly situated" taxpayers requesting APAs, but the identification of "similarly situated" taxpayers is difficult. In particular, "consistency" concerns should not impose a secret standard that the taxpayer cannot by law know. The APA process that has worked well for fourteen years should not be derailed based on consistency concerns that are so fact-bound that they cannot be articulated in generic, published guidance.

- Taxpayers primarily use the APA Program to achieve certainty regarding their tax liabilities. We do not believe that an APA results in a reduced overall tax burden for taxpayers.

- Having the APA Program based in the Office of Associate Chief Counsel (International) allows the APA Program to both appear independent and be independent from IRS Examination and the taxpayer. Therefore, it is our strong recommendation that the APA Program remain in the Office of Chief Counsel (International).

- Within the APA process, we think the present jurisdictional boundaries between the APA Program, IRS Examination and U.S. Competent Authority are appropriate. We recommend that primary jurisdiction be given to the APA Program, rather than the Prefiling Agreement Program, for cases involving attribution of profit to a permanent establishment and effectively connected income of a U.S. trade or business.

- While in recent years bilateral APAs have become more prevalent, we recommend that the Service continue to enter into unilateral APAs, which are more practical in certain instances in terms of taxpayer and government resources.

- Bilateral APAs take two to four times as long to complete as unilateral APAs. The length of time to resolve these APAs creates inefficiencies and substantially increases the cost of

the bilateral APA process. We recommend holding both competent authorities to case plans and fixed time frames to resolve a bilateral APA. Additionally, we recommend the APA Program develop negotiating position papers that can reasonably serve as a basis for a competent authority agreement and the inclusion of the APA Program Team Leader in competent authority negotiations.

- Promised efficiencies for renewal APAs have not been achieved. Renewal APA requests generally take as least as long if not longer on average to resolve than new APA requests. Therefore we recommend limiting the required information to be submitted in a renewal APA and setting more ambitious timeliness goals for renewal APAs such that unilateral renewal APAs and bilateral negotiating positions are completed in six months.

- Under the section 482 regulations and the Organization for Economic Cooperation and Development's ("OECD") Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines") there is recognition that precision cannot be achieved in arriving at transfer prices. Accordingly, statistical methods, such as the interquartile range, are employed to reduce uncertainty and increase reliability. Because the transfer pricing rules already take into account and address this inherent uncertainty, we do not believe that reference by analogy to and additional adjustment for the Heisenberg Uncertainty Principle is necessary.

- We recommend that the APA Program discontinue its position of requiring in certain cases that taxpayers make APA adjustments to the median. APA adjustments are more analogous to a voluntary section 482 adjustment made pursuant to Treas. Reg. §1.482-1(a)(3) rather than as an imposed adjustment pursuant to Treas. Reg. §1.482-1(e)(3), and the imposition of such an adjustment is inconsistent with the OECD Guidelines.

- When the APA Program takes positions on business cycles, we recommend that the APA Program obtain taxpayer input and assistance into how business cycles should be defined for various industries and then publish guidance on the issue.

- Taxpayers come into the APA Program for certainty. Requiring an updating of the arm's length range during the APA term does not achieve that certainty and reduces the benefits of obtaining an APA by requiring the taxpayer to do what it would otherwise have to do for documentation purposes.

- Regarding rollbacks, we recommend that the Service follow its long stated policy to rollback an APA transfer pricing method to a prior period where facts and law are substantially the same for both the APA period and the prior period.

I. Introduction

The Service's flagship Advance Pricing Agreement Program has been subjected to intense public scrutiny throughout its fourteen-year history. Despite this scrutiny and the accompanying resources required to address inquiries and lawsuits, the APA Program has completed over 500 APAs and is the leading program of its kind. Many treaty partners have noted the APA Program's success and developed APA procedures modeled after the U.S. APA Program.

Public scrutiny of the APA Program has come in the form of Congressional inquiries and lawsuits. The APA Program has been considered in several General Accounting Office ("GAO") reports concerning transfer pricing[1] and it was also the subject of a much-followed lawsuit concerning the public disclosure of completed APAs. Under the microscope of public scrutiny, the APA Program's successes have outshined any shortcomings and its value to public tax administration has been internationally recognized by the Service, taxpayers, and foreign tax authorities.

Although GAO referenced the APA Program several times in various reports concerning tax administration, the first full review of the program was requested by Senator Byron L. Dorgan (D-N.D.). The GAO issued a report ("GAO Report") on August 14, 2000, entitled: *Tax Administration: IRS' Advance Pricing Agreement Program* (GAO/GGD-00-168). In analyzing the APA Program's role in public tax administration, the GAO Report did not criticize the heart of the APA Program's mission or its methods of reaching agreements. The GAO Report mostly focused on the APA Program's backlog of cases and timeliness, which paved the way for an expanded APA Program with additional staff members. Then-Commissioner Charles Rossotti, in his response to the GAO, which is appended to the GAO Report, captured the spirit of the report when he stated:

> The main reason APA cases take longer than the ideal to process is resource constraints. In this way, the APA Program has been a victim of its own success. As the Program's reputation for reaching principled, even-handed, practical solutions to some of the most difficult cases facing the IRS and taxpayers has grown, demand for APAs has also grown. Even though we are processing APAs at a record pace, this demand has outstripped the Program's resources.

Public scrutiny was not limited to the GAO's analysis of the APA Program's activities. In 1996, the Bureau of National Affairs, Inc. ("BNA") brought an action against the Internal Revenue Service seeking the public disclosure of all APAs.[2] Among taxpayers, there was widespread protest to the release of APAs and belief that a policy of releasing APAs would chill taxpayers' interest in the APA Program, and, effectively, end the APA Program. Recognizing the vital role the APA Program was providing to public tax administration, Congress interceded by passing

[1] See, Tax Administration: Information on the IRS' International Tax Compliance Activities (GAO/GGD-94-96); Tax Administration: IRS Initiatives to Resolve Disputes Over Tax Liabilities (GAO/GGD-97-71); Tax Administration: Foreign and U.S.-Controlled Corporations That Did Not Pay U.S. Income Taxes, 1989-95 (GAO/GGD-99-39); and, Tax Administration: IRS' Advance Pricing Agreement Program (GAO/GGD-00-168).
[2] See Bureau of National Affairs v Internal Revenue Service, D.D.C., Nos. 96-376, 96-2820 and 98-1473.

provisions protecting APAs as confidential return information and excluding them from disclosure as a written determination.[3]

Announcement 2004-98 solicited comments regarding the operation of the APA Program and suggestions for strengthening the APA Program's performance as part of Chief Counsel's commitment to promoting IRS audit currency. Topics of comments specifically solicited were:

- the state of, and ideas for improving, the accessibility of the APA Program to taxpayers;
- the state of, and ideas for improving, timeliness and efficiency in handling APA matters;
- the state of, and ideas for improving, handling of APA cases in particular industries; and
- the state of, and ideas for improving, the effectiveness of the APA Program generally in furthering the interests of sound tax administration.
- the state of, and ideas for improving, the critical assumption language and/or other features of the standard APA contract;
- the appropriateness/feasibility of updating an agreed arm's length range or point to reflect events occurring during the APA term (e.g., by tying the range or point to an external or internal benchmark); and
- the appropriateness/feasibility of reflecting in the legal and economic analyses underlying an APA the impact that the execution of the APA may have on the relationship between the APA taxpayer and its related party.

II. APA Program Resources

Perhaps, there is no area more sensitive or crucial to the success and utility of the APA Program as its funding. APAs are particularly fact intensive and contain issues that are difficult to resolve, requiring the dedication of a knowledgeable and talented staff. Chronic short-staffing, along with inquiries and lawsuits that have siphoned the APA Program's resources, has plagued the APA Program in recent years. Timeliness goals and case currency are simply not possible without a strong and well-staffed APA Program. We recommend that the APA Program be fully staffed to meet its timeliness goals and be provided additional staff to respond to the government inquiries and lawsuits into its activities.

A thorough and efficient APA process requires travel by the APA team. Functional and risk analyses cannot be performed, verified and relied upon without the APA Team's ability to schedule meetings and interviews during the APA process. Recently, the APA Program has been forced to make difficult choices including for which APAs to travel and what personnel to send (e.g., APA Team Leader or Economist). This significantly hampers the APA process and the taxpayer and APA Program, alike, are disadvantaged. The travel budget situation is grave; we understand that the APA Program's travel budget for the fiscal year beginning October 1, 2004 is $90,000—total. Given that the APA Program may expect about 100 APA requests during a 12-

[3] Ticket to Work and Work Incentives Improvement Act of 1999, Pub. L. 106-70. Section 6103(b)(2)(C) protects APAs as confidential return information and section 6110(b)(1), as enacted in 1999, specifically excluded APAs from the definition of a "written determination." In 2000, section 6110 was subsequently amended, eliminating the direct reference to APAs in favor of excluding APAs as a written determination by reference to section 6103(b)(2)(C).

month period, there is approximately $900 of travel funds available per case. This amount is so low as to frustrate the goals of the APA Program and, while not directly related, appears completely inconsistent with the taxpayers' user fees, which we estimate to be approximately $1.25 million per year. We note that its constrained travel budget puts the Service at a competitive disadvantage with countries such as Canada that place high importance to site visits. It is our understanding that there is no mechanism in place whereby the APA Program may directly fund its travel with user fees collected; however, we recommend that the APA Program's budget in some manner reflect the user fees, which would be in line with expectations of participating taxpayers.

III. Consistency

We agree with the Service's desire to achieve consistency for similarly situated taxpayers under the principles set forth in United States v. Kaiser[4] and International Business Machines Corp. v. United States.[5] As some other commentators have noted, consistency of process and principles is desirable as it bears on whether taxpayers are being treated fairly. However, we do not believe that an attempt to identify similarly situated taxpayers for the purpose of consistent application of substantive transfer pricing rules will necessarily result in the proper application of the section 482 regulations.

The identification of "similarly situated" taxpayers is complex in the context of transfer pricing cases. In general, each product, service, or intangible of a taxpayer is different from another taxpayer's similar product, service, or intangible in some way. Also, one of the most important aspects of a transfer pricing analysis is the functional analysis, which identifies the functions performed, risks assumed, and assets employed by each party to the controlled transaction under review. Functions, risks, and assets may be allocated differently in one controlled group versus another controlled group.

If in the context of APAs, the goal of treating similarly situated taxpayers similarly were interpreted to mean that taxpayers entering the APA Program would be held to a secret standard that they cannot by statute know,[6] such a result would be both inappropriate and damage the APA Program's ability to achieve what it has to date. To hold taxpayers to a secret standard would be adopting an approach that our government has criticized other governments for taking:

> In a December 2001 interview, [then] U.S. Competent Authority Carol Dunahoo said the Internal Revenue Service considered use of secret comparables to propose an adjustment inappropriate. "We do not settle cases on the basis of secret comparables, and our position is widely known among our treaty partners as well as to companies and practitioners . . . ."[7]

As the foregoing indicates, legitimate consistency concerns should be capable of articulation in published guidance. Where, instead, a result turns on data and factors that are highly taxpayer-

[4] 363 U.S. 299 (1960).
[5] 343 F2d 914 (Ct. Cl. 1965), cert denied, 382 U.S. 1028 (1966).
[6] See discussion in section I above regarding the status of APAs under sections 6103 and 6110.
[7] Transfer Pricing Report, Tax Management, Vol. 11 No. 3 at 142 (May 29, 2002).

specific, "consistency" concerns are misplaced. As discussed below, the APA Program historically has been characterized by its perceived fairness and the fact that it is more efficient than other dispute resolution alternatives. We believe that a process that has worked well for fourteen years should not be derailed based on unrealistic expectations and misguided perceptions about that process.

IV. Due Diligence and the Nature of the APA Process

Given the often unprecedented levels of disclosure and cooperation demanded by the APA process, it is not surprising that, as the Chief Counsel succinctly observed, the APA Program appeals "most to companies whose priority is achieving certainty with respect to their US tax liability rather than minimizing it."[8] We are confident that the Service's response to Congress's request for detailed information concerning the APA Program's activities will succeed in addressing any concerns that the APA Program is an elaborate scheme to reduce the tax burden of multinational corporate taxpayers.

We want to emphasize the fact that high levels of commitment and sacrifice on the taxpayer's part have always been critical to the APA Program's mission. As part of the APA process, the taxpayer must supply the IRS prior years' data and future year projections, including projected tax impact, and economic analyses of the transactions to be covered by the APA. The taxpayer most likely has engaged an outside consultant to help prepare these analyses who is at the disposal of the APA Program office. Thus, the information available to the IRS is much more robust – but more narrowly focused - than that given in response to audit inquiries. Taxpayers are, in effect, laying their cards on the table.

The extent to which taxpayers must make extraordinary disclosures in the APA application process was understood very well from the very beginning of the APA Program. Indeed, by 1994 the Office of the Associate Chief Counsel (International) was already able to acknowledge that entrance into the APA Program required certain sacrifices by taxpayers that have benefited the IRS:

> Taxpayers have voluntarily disclosed extensive (and sensitive) information about their operations and methods, to educate the IRS about their businesses. They have prepared and disclosed analyses of themselves, their markets, and their competition that heretofore have rarely, if ever, been made available to IRS agents.[9]

The APA process is necessarily a process of give-and-take. For example, both the taxpayer and the Service must be willing to work together cooperatively in order to reach a mutually acceptable transfer pricing method and result. In exchange for giving up certain leeway inherent in the transfer pricing regulations, the taxpayer will achieve certainty. This is a

[8] Remarks Before the Global Transfer Pricing Forum 2004, Donald L. Korb, Chief Counsel for the Internal Revenue Service, September 29, 2004.
[9] The Advance Pricing Agreement Program (APA): A Model Alternative Dispute Resolution Process, Part I, Office of Associate Chief Counsel (International) (May 11, 1994).

worthwhile trade-off for taxpayers who wish to avoid the costly and disruptive impact of contentious transfer pricing audits.

The Service also obtains benefits from resolving a potentially contentious transfer pricing issue, as an APA consumes significantly less government resources than litigating a transfer pricing case. In addition, the mutual resolution of transfer pricing issues through the APA Program is consistent with the Service's initiatives to resolve tax controversy issues on a more current basis.

In a letter to the APA Program, members of the Senate Finance Committee have suggested that the APA Program is allowing multinational enterprises to avoid paying an appropriate level of U.S. tax through unilateral or bilateral APAs.[10] Moreover, the letter suggests that defense of the U.S. tax base should be ascertained by comparing transfer pricing methods ("TPMs") agreed to in the APA context to what IRS Examination proposed as a TPM. In our experience, IRS Examination (or the examination function for other tax authorities) often proposes a TPM that will produce the maximum possible allocation to the domestic tax base. This is normal and expected. Thus, comparison of agreed upon TPMs, often involving bilateral agreement of foreign tax authorities, with IRS Examination proposals taken as a basis for measuring a transfer pricing "gap" has little meaning. Indeed, this is self-evident from the sustention rate of IRS Examination in IRS Appeals, which is typically in the 30% range for section 482 adjustments.[11]

That the APA Program is most decidedly not a venue for implementing aggressive tax ploys was captured very well by the Chief Counsel in his remarks to the 2004 Global Transfer Pricing Forum in Berlin:

> In return for [certainty], taxpayers must make certain commitments and investments. They have to make the upfront investment of time and money to prepare the APA submission and, more importantly, they have to commit themselves to working with the IRS on a cooperative basis. This means volunteering detailed information about their business activities, plans, competitors, market conditions, and their view of an appropriate transfer pricing method. And they commit to provide this information in a coherent and timely way - again, working with the Service in a cooperative, consensus- and trust-building way. Adopting an approach, in short, that is quite different from the adversarial posture taxpayers sometimes take in examinations and the polar opposite of their approach in litigation.[12]

V. Organizational Structure of the APA Program

The APA Program was borne out of the desire to resolve transfer pricing issues both fairly and more efficiently. Fairness is a perception. The APA Program has achieved its success because its leaders have been perceived as fair in both fact and in appearance. While there are many

[10] "U.S. Lawmakers Ask IRS if Multinationals Pay 'Fair Share' of Taxes," 2003 WTD 246-12.
[11] Report on Application and Administration of Section 482, Internal Revenue Service, Publication 3218, (April 21, 1999), Appendix C.
[12] Remarks Before the Global Transfer Pricing Forum 2004, Donald L. Korb, Chief Counsel for the Internal Revenue Service, September 29, 2004.

skilled international examiners in transfer pricing, there is a fundamental perception by taxpayers that fairness cannot be obtained in having the Service's examination teams, which are responsible for making audit adjustments, in charge of a voluntary dispute resolution process. Placing the APA Program in the Office of Associate Chief Counsel (International) gave the APA Program both the appearance of independence and actual independence from the examination function of the LMSB Division and the taxpayer.

Over the years, the independence of the APA Program has provided the credibility with taxpayers essential to reaching agreement on difficult transfer pricing issues. While perhaps this reputation could be maintained if the APA Program was run by the LMSB Division, it is just as likely that it could jeopardize the future of the APA Program. Therefore, it is our strong recommendation that the APA Program remain in the Office of Chief Counsel (International). While it has been suggested that the APA Program might be structured as an independent entity similar to Appeals, we believe that such a change is unnecessary and has little to recommend it other than formal separation from LMSB.

VI. Relationship Between the APA Program, Tax Treaty, LMSB, and Other Internal Revenue Service Functions

Because of differing jurisdictions, the APA process is one where various functions of the Service must work together to address an APA request. An APA resolves transfer pricing issues on a prospective basis.[13] Thus, the filing an APA request does not suspend any examination or other enforcement proceedings.[14] However, in appropriate cases, a transfer pricing method (TPM) agreed to in an APA may be applied to tax years prior to those covered by the APA (a so-called "rollback" of the TPM).[15] In this context, IRS Examination has jurisdiction to determine whether the rollback will be applied.[16] Similarly, if a rollback is requested in connection with a bilateral APA, the rollback will be handled in the Competent Authority process.[17] We think these jurisdictional boundaries between the APA Program, IRS Examination and U.S. Competent Authority are appropriate, although we have some comments below regarding rollbacks.

While we believe that the boundaries are appropriate, often the Service assigns people to the APA Team who have no clearly defined role. As an example, a Division Counsel attorney is assigned, as a matter of procedure, in each APA case.[18] Often there is no defined role for the attorney in processing the APA request - particularly in cases where the attorney has no history with the taxpayer and the taxpayer has made no rollback request. As at least one commenter has noted, the "piling on" of Service personnel on APA requests is inconsistent with the Internal Revenue Manual's provision of "assign[ing] personnel with a view toward efficiency" and minimizing the number of people on the APA Team "consistent with effective evaluation of the

[13] Rev. Proc. 2004-40, 29 I.R.B. 50 (July 1, 2004) at § 2.01.
[14] Id. at § 2.13.
[15] Id. at § 2.12 and § 7.
[16] Id. at § 7.05.
[17] Id. at § 7.03.
[18] Id. at § 5.04.

case and with reasonable training needs of the Service."[19] We agree with the policy in the Internal Revenue Manual and urge the Service to apply it in practice.

We observe that one issue prominently noted in the current U.S. Senate Finance Committee inquiry of the APA Program concerns whether the positions of Examination (LMSB) are appropriately taken into account in resolving the APA. In our experience, Examination positions are forcefully presented and taken into account in the APA process, both within the APA Team as well as in meetings with the taxpayer.

Where Examination positions do not prevail, as with the positions of other members of the APA Team, it is because of the combined determination of the Service's APA Team composed of constituent members from all appropriate areas of the Service.

VII. Relationship Between the APA Program and LMSB's Prefiling Agreement Program

The APA Program has jurisdiction to resolve transfer pricing issues under Section 482 of the Code, the income tax regulations under Section 482, and relevant income tax treaties to which the United States is a party.[20] Historically, the APA Program has exercised its jurisdiction applying section 482 principles to determine the branch income of both foreign based companies operating U.S. branches and U.S. based companies operating foreign branches. In fact, since its inception through 2003 (the last year for which the APA Program has published its annual report), the APA Program has entered into 55 such APAs, of which at least 47 were financial product APAs.[21] In 2002, then-Associate Chief Counsel (International) John Staples announced that the APA Program would no longer accept non-financial product branch APAs.[22] The stated rationale for turning away these cases was that "there is no current doctrine that applies section 482 to attribution of profit to [a permanent establishment]" and that the jurisdiction of the APA Program was limited to section 482 issues under its procedures at the time (Revenue Procedure 96-53).[23]

Pursuant to newly issued Revenue Procedure 2005-12,[24] attribution of profit to a permanent establishment can now be addressed in the Pre-Filing Agreement ("PFA") Program. The PFA

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[19] Comments of Alan W. Granwell, citing Internal Revenue Manual 42.10.11.1 (formerly, Chief Counsel Directives Manual (42)(10)(11)0(1)).

[20] Rev. Proc. 2004-40 at § 2.01.

[21] The breakdown of the 55 branch APAs are as follows:

1991-1999	U.S. branches of foreign companies	27
	Foreign branches of U.S. companies	8
2000	U.S. branches of foreign companies	8
2001	U.S. branches of foreign companies	6
	Foreign branches of U.S. companies	2
2003	U.S. branches of foreign companies	4

The amounts were compiled from Announcement 2000-35, 2000-1 C.B. 922; Announcement 2001-32, 2001-1 C.B. 1113; Announcement 2002-40, 2002-1 C.B. 747; Announcement 2003-19, 2003-15 C.B. 723; and Announcement 2004-26, 2004-15 I.R.B. 743 (Mar. 16, 2004).

[22] Moses, "Staples Responds to Charges that IRS Cutting APA Scope: Says Program Should Not Lead Policy Charge in PE Area," Tax Management Transfer Pricing Report, Vol. 11 No. 1, May 1, 2002, at 23.

[23] Id.

[24] Rev. Proc. 2005-12, 2005-3 I.R.B. 311 (Dec. 22, 2004).

Program is under the jurisdiction of LMSB.[25] However, LMSB personnel must consult with the Associate Chief Counsel having subject matter jurisdiction over any issue raised by a PFA request. In addition, certain issues require the concurrence of the Associate Chief Counsel International.[26]

While a PFA can involve "any issue that requires either a determination of facts or the application of well-established legal principles to known facts"[27] and issues involving a methodology "to determine the appropriate amount of an item of income,"[28] the following issues require concurrence of the Associate Chief Counsel (International):

> (1) whether a unit of the taxpayer's trade or business is a qualified business unit within the meaning of section 989(a) and the regulations promulgated under that section;
> (2) whether the taxpayer is engaged in a trade or business within the United States (excluding questions under section 864(b)(2));
> (3) the amount of gross income that is effectively connected with the conduct by the taxpayer of a trade or business within the United States;
> (4) factual determinations concerning the extent to which, under section 882(c), deductions are connected with income that is effectively connected with the taxpayer's conduct of a trade or business within the United States; and
> (5) whether the taxpayer has a permanent establishment in the United States for purposes of a bilateral income tax convention to which the United States is a party and, if so, what profits are attributable to that permanent establishment.[29]

With respect to permanent establishment ("PE") issues, we recommend that primary jurisdiction lie within the APA Program, with involvement of appropriate personnel from tax treaty personnel from LMSB for bilateral requests,, and others from LMSB and Associate Chief Counsel (International). OECD's Discussion Draft on Attribution of Profits to PEs – Part I, recently released on August 2, 2004, endorses the "functionally separate entity" approach and describes the OECD authorized approach to determining profit attributable to a permanent establishment as follows:

> The interpretation of Article 7(2) under the authorised OECD approach is that a two-step analysis is required. First, a functional and factual analysis in order to appropriately hypothesise the PE and the remainder of the enterprise (or a segment or segments thereof) as if they were associated enterprises, each undertaking functions, using assets, and assuming risks. Second, an analysis of the [OECD Transfer Pricing] Guidelines relevant to applying the arm's length principle to the hypothesised enterprises so undertaking functions, using assets, and assuming risks. Section C-2 below discusses the factual and functional analysis and the attribution of functions, assets, risks and "free" capital to the PE. Section C-3 below discusses the attribution of profits to the PE in accordance with its functions, assets used and risks assumed by comparison to independent enterprises

[25] Id. at § 1.01.
[26] Id. at § 3.06.
[27] Id. at § 3.03(1).
[28] Id. at § 3.03(2).
[29] Id. at § 3.06.

> performing the same or similar functions, using the same or similar assets and assuming the same or similar risks…[30]

The two-step analysis described above is clearly within the core competency of the APA Program and essentially what it is already doing in its consideration of APA requests, particularly, financial trading APAs.

Also, we note that the PFA procedures, while encouraging a taxpayer to seek competent authority consideration in connection with its APA request, adopt a procedure that was formally abandoned by the APA Program in 1996. Under the PFA procedures, the Service would conclude a PFA with a taxpayer and then take the concluded agreement to competent authority.[31] Similarly, when the APA Program first started, the procedure for bilateral APAs was that the Service would execute a unilateral APA with a taxpayer and then seek a similar agreement with the other tax authority. However, because the other tax authority had not been involved in reaching the unilateral agreement, reaching agreement on a bilateral APA was difficult. In these cases, bilateral agreements often were concluded that differed substantially from the unilateral APA. This called into question whether the whole process of negotiating a unilateral APA was wasteful, since it was apparent that a different agreement would be reached by the competent authorities. In 1996, the Service abandoned this approach in favor of negotiating positions prepared by the APA Program for use by the U.S. competent authority in negotiating the APA with the other tax authority. While a commentary on the PFA procedures is beyond the scope of our recommendations, we recommend that permanent establishment cases be within the primary jurisdiction of the APA Program, with involvement of appropriate personnel from tax treaty personnel from LMSB for bilateral requests, and others from LMSB and Associate Chief Counsel (International). This is an opportunity to leverage the APA Program's considerable experience in such matters.

While the issue of whether an entity is involved in a U.S. trade or business and the income effectively connected with such trade or business differs somewhat from the permanent establishment issues discussed above, we believe that it is sufficiently similar to the PE issue. Ultimately, one must assess what functions are being performed and the appropriate level of income to be reported consistent with the arm's length standard. For the reasons cited in this section and for reasons cited in the section above regarding the organization structure of the APA Program, we recommend that the APA Program be given primary jurisdiction over such issues.

VIII. Unilateral APAs

Since 1996, the IRS has expressed a clear preference for devoting APA Program resources to bilateral and multi-lateral APAs as opposed to unilateral APAs. In Revenue Procedure 96-53, this preference was stated as follows:

> To minimize taxpayer and governmental uncertainty and administrative cost, bilateral or multilateral APAs generally are preferable to unilateral APAs when competent authority procedures are available with respect to the foreign country or countries involved. In

[30] OECD Discussion Draft on Attribution of Profits to PEs – Part I, ¶ 54. The reference to "Guidelines" is to OECD's Transfer Pricing Guidelines for Multinational Enterprises and Tax Administrations ("OECD Guidelines").
[31] Rev. Proc. 2005-12, §3.07(2).

> appropriate circumstances, however, the Service may execute an APA with a taxpayer without reaching a competent authority agreement. The taxpayer must show sufficient justification for a unilateral APA. When a unilateral APA request involves taxpayers operating in a country that is a treaty partner, the Service may notify the treaty partner of the filing of the request and provide the treaty partner with other information related to the request, under normal rules governing the exchange of information under income tax treaties. In some circumstances, procedures agreed upon with particular foreign competent authorities, or the requirements of proper relations with treaty partners, may preclude unilateral APAs.[32]

In addition to similar language cited above, Revenue Procedure 2004-40 requires that a taxpayer requesting a unilateral APA involving a treaty jurisdiction provide in the APA request "an explanation of why the request is not bilateral."[33]

Given the undeniable benefits afforded a taxpayer by an upfront, multi-year agreement between jurisdictions over its transfer pricing, we believe it is safe to assert that unilateral APAs would become a thing of the past if the amount of time spent, resources committed, and certainty of eventual success were the same for bilateral and unilateral APAs. However, the reality is that the costs and risks are not equal. Bilateral APAs take a substantially longer time to process than unilateral APAs. Based on statistics reported in the APA Program annual reports for 2003, the average and median processing times for completing a unilateral APA in 2003 was 20.0 and 9.2 months, respectively; in comparison, similar measures for bilateral and multilateral APAs were 41.5 and 39.4 months, respectively.[34] Thus, at best, one can say a bilateral APA takes twice as long as a unilateral APA; at worst, it takes over four times as long. Moreover, bilateral APAs involve significantly greater upfront investment of taxpayer resources and may involve a greater degree of uncertainty in terms of outcome.

Certainty regarding the U.S. tax results of one's transfer pricing is, in itself, very valuable. Both a taxpayer and the Internal Revenue Service can save significant amounts of audit time if a transfer pricing issue can be excluded upfront from an examination. Given the resource constraints of the Service's international examiners, this is very beneficial to the Service. In addition, it is often not practical to have a bilateral or multilateral APA because of the number of other jurisdictions involved or the particular jurisdiction involved. For example, a U.S. taxpayer might import and export $50 million of products from and to affiliates located in 20 different countries. While this may be a significant transfer pricing issue for the taxpayer in the U.S., the largest amount traded with one specific country might be only $5 million. The marginal benefits offered by a multilateral APA in a situation like this would probably not justify the time and expense involved in negotiating between the U.S. and the other jurisdictions involved.

While the Service prefers bilateral APAs, we note that the Service acknowledges the usefulness of unilateral APAs in its willingness to negotiate correlative relief by not subjecting a taxpayer entering into a unilateral APA to limitations on correlative relief set forth in section 7.05 of Rev.

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[32] Rev. Proc. 96-53, §7.07.
[33] Rev. Proc. 2004-40, §6.06 and §4.01(11).
[34] Announcement 2004-26.

Proc. 2002-52.[35] This limitation provides that if a taxpayer reaches a settlement on an issue pursuant to a written agreement, then the U.S. competent authority will endeavor only to obtain a correlative adjustment from a treaty country and will not undertake any actions that would otherwise change such agreement.

While the very real differences between bilateral and unilateral APAs in terms of benefits and costs force taxpayers to make a choice as to the variety of APA they desire, we believe the choice is one that the taxpayer is best-equipped to make. Although we are cognizant of today's environment of worldwide transfer pricing enforcement, the unilateral APA remains a valuable, important component of the APA Program. Our network of interstate highways remains a vital part of the nation's transportation system even though air travel has been shown to be generally safer and more convenient than travel by automobile. Likewise, we hope that the APA Program continues to recognize the substantial value of unilateral APAs and devotes a sufficient portion of its increasingly limited resources to their completion.

IX. Bilateral APAs

As we noted above, it presently takes approximately three to four years to resolve a bilateral APA case. The length of the process creates inefficiencies and substantially increases the cost of obtaining a bilateral APA. We recommend that case plans be made with each treaty partner to resolve a bilateral APA request within one year of the exchange of positions. Also, consistent with reducing the amount of time to process bilateral APAs, we recommend that the U.S. negotiating positions be completed within nine months, which was the APA Program's stated goal prior to issuing Revenue Procedure 2004-40.

In order to meet these time frames, we recommend that Competent Authority personnel become involved early in the process in a substantive way and engage in regular discussions with the foreign competent authority prior to receiving the formal negotiating position paper from the APA Program.

Unfortunately, we have seen bilateral APA requests where the U.S. negotiating position has little to no prospect for success in negotiations with other competent authorities. In order to prevent this from occurring, we recommend the following language be added to section 2.09 of Rev. Proc. 2004-40 (added language is underscored):

> In a bilateral or multilateral case, the APA Program prepares a recommended negotiating position for the U.S. Competent Authority. The negotiating position serves as a basis for both discussion <u>and agreement</u> with the relevant foreign competent authority or authorities under the mutual agreement article of the applicable income tax treaty or treaties. Prior to finalizing its recommendation, the APA Program through the Team Leader (see section 5.03) conveys the substance of the APA Team's position to the taxpayer to provide an opportunity for the taxpayer to comment. The Team Leader, in coordination with other members of the APA Team, considers the merits of the taxpayer's timely received comments in finalizing the recommended position.

[35] Rev. Proc. 2004-40, § 6.07. The Service has also provided for similar treatment for "unilateral PFAs." See Rev. Proc. 2005-12, § 7.02(3).

Recommended negotiating positions should be based on generally applicable standards reflected by (a) the OECD Guidelines, (b) the course of dealing with the applicable treaty partner, and to the extent not covered by (a) or (b), applicable §482 Regulations.

Lastly, we believe that it is important for the APA Program Team Leader to attend and participate in the competent authority discussions. Often it is the Team Leader who is the most familiar with the facts and positions taken in the case. Working together as a team in these negotiations, the competent authority analyst and Team Leader can only improve the U.S. position at the competent authority negotiating table.

X. Renewal APAs

As other commentators have noted, renewal APAs have been problematic for the APA Program. In its most recent annual report for 2003,[36] the APA Program reported that for bilateral APAs, new and renewal APAs took the same amount of time on average to complete, 41.2 and 42.3 months, respectively; however, the median processing time for renewal bilateral APAs exceeded the median processing time to complete new bilateral APAs by almost 15 months (50.2 months compared to 35.4 months). For unilateral APAs, while renewal APAs took on average 6 months less to complete than new APAs (16.2 months compared to 22.3 months), half of all renewal APAs took 1.3 months longer to complete than new APAs (9.8 months compared to 8.5 months).

From these statistics, we conclude that the promised efficiencies of requesting renewal APAs are not being achieved. To obtain these efficiencies, we recommend that the following procedures for renewal APAs be instituted:

(1) A taxpayer's APA request will be limited to the following items: (a) all submissions made to the IRS and foreign tax authority in the prior APA request; (b) copy of the prior APA; (c) copies of all annual report filings in the prior APA; and (d) an update submission to indicate any changes in facts, law, and requested transfer pricing methodology compared to the prior APA and to discuss application of the transfer pricing methodology under the prior APA.

(2) Unilateral APAs and negotiating position papers for bilateral APAs will be completed within 6 months.

XI. Heisenberg Uncertainty Principle

Announcement 2004-98 requested comments on the appropriateness/feasibility of reflecting in the legal and economic analyses underlying an APA the impact that the execution of the APA may have on the relationship between the APA taxpayer and its related party, which was referred to as the "Heisenberg Uncertainty Principle" in recent public comments by Chief Counsel Korb.[37]

The Heisenberg Uncertainty Principle ("HUP"), articulated in 1927 by the German physicist Walter Heisenberg, suggests that there exists some irreducible uncertainty in every measurement

[36] Announcement 2004-26.
[37] Transfer Pricing Report, Tax Management, Vol. 13 No. 16 at 855 (December 22, 2004) quoting Chief Counsel Korb at the IRS-George Washington University International Tax Conference on December 10, 2004.

of position and momentum, because the act of measurement itself has potentially influenced the physical characteristics of the measured phenomenon. We gather that the thesis behind HUP's application to APAs is the notion that the mere act of entering into an APA has in some fashion changed the underlying relationship of the related parties.

In our view, this suggestion confuses the intercompany contractual undertaking with the metric used to measure the arm's-length nature of that intercompany relationship. Transfer pricing, structurally, is reflected by the contractual undertaking and the conduct of the related parties. Whether or not one or both of the related parties engaged in such intercompany relationship seeks advance approval from an affected taxing authority, the contractual undertaking is what it is. An agreement with the government(s) does not change the underlying transaction but only provides an imprimatur of conditional acceptance.

Consequently, an APA does not change a function or risk, it *recognizes* the functions and risks already present. The APA does not guarantee a return to any party, it merely notes that given a certain stream of income (which the parties still bear the risk of producing), the likely division parties acting at arm's length would likely make.

Heisenberg and his followers noted that what might be critically important in a world of electrons might not be all that crucial for decision-making in everyday life. In short, some level of uncertainty can be tolerated in some settings more readily than in others. No one could seriously contend that APAs remove all uncertainty; indeed, "critical assumptions" are a testament to that irreducible uncertainty. The "science" of transfer pricing is not such a precise tool that one ought to premise the arm's-length principle on such fine lines. To the contrary, the arm's-length standard recognizes fluidity and *standardized* imprecision (*e.g.*, through its adoption of the "range" concept). Thus, the question posed by Announcement 2004-98 operates from a flawed premise that absolute certainty is derived by APA "contracts" with one of the two related parties, when even those contracts have explicit and implicit conditions subsequent.

Another relevant frame of reference is the discussion in the §482 Regulations of the need to make adjustments in the adoption of transfer pricing methodologies to reflect observed material differences between the tested transactions and the comparable transactions, *where the appropriate adjustment is reasonably ascertainable*.[38] It follows that adjustment ought not be made where the appropriate adjustment is not reasonably ascertainable. Given that "uncertainty" (which is, quite literally, HUP's middle name), it might be suggested that the current Regulations proscribe an adjustment, even assuming *arguendo* that APA memorialization of an arm's-length range could be deemed somehow to alter the "best method analysis" itself.

Furthermore, it could be said that the present section 482 regulations and the APA Program's applications thereof already incorporate the HUP concept. Where Heisenberg theorized that the more precisely position is determined, the less precisely momentum is known, complex

[38] "If there are material differences between the controlled and uncontrolled transactions, adjustments must be made if the effect of such differences on prices or profits can be ascertained with sufficient accuracy to improve the reliability of the results… If adjustments for material differences cannot be made, the uncontrolled transaction may be used as a measure of an arm's length result, but the reliability of the analysis will be reduced… The extent and reliability of any adjustments will affect the relative reliability of the analysis." Treas. Reg. §1.482-1(d)(2)

statistical analysis provided measurements for *likely* results—so, where precision is lacking, statistical methods are utilized. The same approach is inherent in transfer pricing analysis under the Regulations and OECD Guidelines. Because precision cannot be achieved in arriving at transfer prices, statistical methods, such as the interquartile *range*, are employed to reduce uncertainty and increase reliability.[39]

We would suggest that the APA Program and IRS might be better served to leave the debate about quantum mechanics to the physicists.

XII. APA Adjustments

In negotiating unilateral APAs, often the APA Program will insist that if an adjustment is necessary to bring a tested party within the arm's length range, such adjustment should be made to the median of the arm's length range. As support for its position, the APA Program cites Treas. Reg. §1.482-1(e)(3), which states that in cases where the IRS has imposed a section 482 adjustment, the adjustment will ordinarily bring a taxpayer's results to the mid-point of the arm's length range.

Treas. Reg. §1.482-1(a)(3) permits a taxpayer to report its "true" taxable income that reflects arm's length pricing. Under this regulation, a taxpayer is permitted to report results that are different from the results reported from transactional prices.[40] Known as a "voluntary section 482 adjustment", the only limitation on such adjustment is that a taxpayer cannot decrease its taxable income on an amended return.[41] More specifically, with respect to a voluntary section 482 adjustment, there is no requirement that such adjustment be to the median.

For two reasons we submit that the APA process is more akin to a voluntary section 482 adjustment under Treas. Reg. §1.482-1(a)(3) rather than an adjustment imposed by the IRS pursuant to Treas. Reg. §1.482-1(e)(3). First, because the APA process is a <u>voluntary</u> process,[42] effectively it is the taxpayer making the adjustment on its own initiative. Second, because the APA request is filed prior to the filing of a tax return for the first covered APA year, the timing of such adjustment is more similar to a voluntary section 482 adjustment, ordinarily made prior to filing of the tax return, than to a section 482 adjustment imposed on a filed return after examination by the IRS.

We also note that it is relatively rare (if it has occurred at all) in a bilateral APA case that an APA adjustment was required to be made to the median. In fact, in the APA Program's annual report for 2003, 24 out of 54 reported APAs adjusted to the closest edge of the range[43] and we assume that these were mostly, if not all, bilateral APAs.

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[39] See Treas. Reg. §1.482-1(e)(2)(iii)(B) (employing statistical methods to adjust a range to increase reliability).
[40] See Preamble to section 482 regulations (…"the taxpayer may report an arm's length result on its original tax return, even if such result reflects prices that are different from the prices originally set forth in the taxpayer's books and records."), T.D. 8552.
[41] Treas. Reg. §1.482-1(a)(3).
[42] Rev. Proc. 2004-40, § 2.01.
[43] Announcement 2004-26.

Lastly, we note that the concept of adjusting taxpayers to the median in every case is inconsistent with the OECD Guidelines which require "adjustments to be made to the point within the range that best reflects the facts and circumstances of the particular controlled transactions."[44] However, we agree that it is appropriate for the Service to inquire in a taxpayer's annual report as to why a tested party's results were at the bottom, at the top, or near the median of the range.

XIII. Business Cycles and Ranges Derived from Multiple Year Data

Many APAs adopt the comparable profits method (CPM) as the transfer pricing methodology.[45] In applying the CPM, the section 482 regulations recommend a three year period:

> The profit level indicators should be derived from a sufficient number of years of data to reasonably measure returns that accrue to uncontrolled comparables. Generally, such a period should encompass at least the taxable year under review and the preceding two taxable years. This analysis must be applied in accordance with §1.482-1(f)(2)(iii)(D).[46]

Similarly, the Preamble to the section 482 regulations states as follows:

> In determining an arm's length result under the CPM, the taxpayer's average reported operating profit for the year under review and the preceding two taxable years ordinarily will be compared to the average result of the uncontrolled comparables for the same period.[47]

Also, Treas. Reg. §1.482-1(f)(2)(iii) states that it is appropriate to consider data from multiple years depending on a variety of factors, including the effect of relevant business cycles in the taxpayer's industry and whether use of multiple year data would "reduce the effect of short-term variations that may be unrelated to transfer pricing." Unlike the CPM regulation cited above, this regulation states no preference for the number of years to include when applying multiple year data.

Many taxpayers requesting an APA are content to accept the default rule of three years in applying the CPM and not make any issue of it. For many years, the APA Program was content with this as well. However, sometime around 2003, the APA Program began to regularly assert that the business cycle of certain taxpayers' industries required a longer period of five years. When asked how the APA Program measured a business cycle, there was never a clear objective standard articulated. If the Service is going to take positions based on the length of taxpayers' business cycles, we recommend that they obtain taxpayer input and assistance into how business cycles are defined for various industries and then publish guidance on the issue.

[44] OECD Guidelines, ¶1.48.
[45] The APA Program annual report for 2003 cites 38 uses of the CPM out of 87 total transfer pricing methods in APAs. Announcement 2004-26, Tables 16, 17 and 18.
[46] Treas. Reg. §1.482-5(b)(4).
[47] T.D. 8552.

XIV. Critical Assumptions

As requested in Announcement 2004-98, we considered whether there should be changes in the APA Program's approach to critical assumptions, including whether the model APA language on critical assumptions should contain more specificity.

We believe that the standard critical assumptions work well and where there are concerns either by the taxpayer or the APA Program appropriate language is agreed upon. Therefore, we recommend no changes in current practice.

XV. Updating Range During the APA Term

The APA Program has asked for comments on the appropriateness/feasibility of updating an agreed arm's length range or point to reflect events occurring during the APA term (e.g., by tying the range or point to an external or internal benchmark). We believe that this requirement would greatly lessen the benefits that an APA offers: certainty and avoiding the need for contemporaneous documentation.

With respect to certainty, in the case of an APA that sets a transfer price for the on-going sale of goods and services among members of multinational groups, the TPM established in an APA provides certainty not only as to tax results but also for business operations. From an organizational standpoint, it is very cumbersome and costly to implement a new transfer price, requiring dissemination to all affected group members with the consequent change to their internal accounting systems. Further, it also requires changes in the prices submitted to customs authorities for purposes of computing duties.

A major benefit to having an APA is that there is no requirement to provide contemporaneous transfer pricing documentation under section 6662 during the term of the APA. Production of such documentation is costly and time consuming. The requirement to update a range would involve much of the same work that is required to create such documentation and hence would negate this benefit. Additionally, many taxpayers will not invest in this process unless they know that they have an agreement for a period of time, and do not have to renegotiate a new range with the Service on an annual basis. Therefore, we strongly recommend that there be no requirement to update the range during the APA term.

XVI. Rollbacks

Obtaining a rollback is an important aspect for taxpayers entering the APA Program. One commentator has recommended that the Service provide notification to the taxpayer within thirty days after responding to the Service's first information request indicating whether rollback treatment will be applied.[48] We agree with this recommendation and we would go even further

[48] Comment letter of Ernst & Young LLP (January 27, 2005).

by recommending that the Service advise a taxpayer in the prefiling meeting as to whether the proposed transfer pricing method is suitable for a rollback.

Regarding how the new APA Program procedures[49] addressed rollbacks, the new procedures initially appear to follow prior procedures by stating that it is Service policy to rollback the agreed upon transfer pricing method to a prior period if the facts and law are consistent between the APA period and the prior period.[50] However, the new procedure includes a new section specifically devoted to rollbacks. While this new section cites the aforementioned Service policy, it also states as follows:

> The balance of prospectivity and retroactivity of the total number of years covered by the proposed overall agreement, and the status of any on-going examination, will also be given consideration in the Service's decision to entertain a rollback request.[51]

Although the Service can agree that a particular transfer pricing method is the best method for a future period and the facts and law are substantially the same for the prior period, the Service may deny the rollback request because it dislikes the result derived by the method in the prior period. We think this is inappropriate, and in the area of rollbacks, we recommend the Service reflect on its consistency concerns.

[49] Rev. Proc. 2004-40.
[50] Id. at § 3.12; Rev. Proc. 96-53 at § 3.06.
[51] Rev. Proc. 2004-40, § 7.02.